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ABSTRACT

The suitability of tax-exempt tuition investment programs to help parents meet college costs is analyzed, with attention to proposed and existing tuition investment plans, other options, organizational and administrative issues, and tax issues. Tuition prepayment plans allow parents to make investments on a sliding scale according to the child's age in order to lessen the effects of future tuition inflation. Under some plans, parents can avoid paying taxes on dividends. Prepayments can also be used to guarantee no tuition increase for 4 years. Proposed state operated plans for Michigan, Wisconsin, and New Jersey are described, along with plans now offered by seven private colleges. Other means of financing tuition are also briefly considered: loan programs, education savings accounts, index tuition/standard tuition unit plan, and commercial plans. Six elements for designing a plan are examined, including the type of agreement, administrative structure, and options for withdrawal of benefits. Advantages/disadvantages of a tuition investment program for the state and for the family are identified. Appendices include a copy of the relevant legislation, Illinois Senate Resolution 782. (SW)

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STATE OF ILLINOIS
BOARD OF HIGHER EDUCATION

THE SUITABILITY OF TAX-EXEMPT TUITION INVESTMENT PLANS FOR ILLINOIS HIGHER EDUCATION

I. Introduction

On May 13, 1986, the Illinois Senate adopted Senate Resolution 782, directing the Illinois Board of Higher Education to analyze the suitability of tax-exempt investment programs to assist parents in meeting the costs of higher education for their children.

A complete copy of the Resolution is attached as Appendix A, but of particular importance is a portion of the Resolution stating:

> "RESOLVED, by the Senate of the Eighty-Fourth General Assembly of the State of Illinois, that the Illinois Board of Higher Education analyze the suitability of a tax-exempt investment plan for the State of Illinois and submit a report by December 1, 1986 to the General Assembly relative to their analysis; and be it further
>
> RESOLVED, That the Board of Higher Education seek the assistance of the State Treasurer, the Illinois Economic and Fiscal Commission, the Bureau of the Budget, the Illinois State Scholarship Commission and any other stage agency it deems could be helpful in the analysis and preparation of the report;..."

With the cost of higher education rising and federal assistance eroding in a number of areas, some colleges, universities and state agencies are beginning to provide financial services to students and their parents. New and sometimes innovative payment plans have emerged, ranging from revolving loan funds financed by college endowments to the tuition equivalent of the futures market -- paying today's prices for a college education in the future.

The programs frequently involve the investment of monies for a child in an account with a state or institution of higher education for tuition payments in the future years when the child will attend college. A number of variations of this plan exist for both private and public colleges, and the variety in the forms of the plans offered

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is analogous to the variety and diversity of the field of higher education itself. Tuition futures plans, gift certificates, credit card payments, tuition matching and loan payments provide a variety of options for college financing.

The institutions that have adopted plans allowing for tuition prepayment or tuition stabilization are finding themselves playing the roles of banker, loan insurer, portfolio manager, actuary, investment advisor, and family financial planner. Some of the plans are marketing concepts designed to attract students, while others are complicated long-term investment programs requiring professional expertise.

Given the rapid growth of activity in this arena (over 250 colleges have such plans and they are being considered in over half of the states) and the directive of Senate Resolution 782, this paper examines the issues surrounding the suitability of such a plan for Illinois by reviewing some of the existing plans and highlighting the options available and the complexities inherent in devising such a plan.

The following sections of this paper describe proposed and existing tuition investment plans in other states; organizational and administrative issues related to establishing a tuition investment plan in this state; tax issues related to tuition investment plans; and the suitability of a tuition investment plan for Illinois.

II. Existing Tuition Investment Plans

The National Association of College and University Business Officers (NACUBO) is currently surveying all institutions to gather information about tuition financing programs. NACUBO plans to publish their findings early in 1987. As of September 1986, the survey revealed over 250 such plans in existence.

Tuition prepayment plans are based on the theory that investments set on a sliding scale according to the child's age will give families a hedge against future tuition inflation. Parents can also avoid paying taxes on dividends under some of these plans. Under other plans, some institutions have devised plans to stabilize tuition for four years by using prepayments to guarantee that there will be no tuition increase.

Critics of the plans argue that unwary parents could end up with less savings or fewer options for choice of schools than had they used conventional investments. Purchasers of tuition futures are exposed to the risk that their children may be unable or unwilling to attend the designated college or university.

In spite of these criticisms, public and private institutions of higher education, state agencies, and private sector commercial institutions offering these types of loan and payment programs continue to increase. A representative sample of such programs is described in the following sections.

Proposed State Operated Plans

Michigan. The most widely publicized among the state plans is the proposed Baccalaureate Education System Trust (BEST) in Michigan. The plan has passed one chamber of the Michigan General Assembly and is being considered by a Senate committee during their Fall 1986 session. The legislation outlining BEST proposes an independent agency, within the Department of the Treasury, governed by its own board.

The function of the trust would be to "contract, on behalf of the state, with purchasers for the advanced payment of tuition for a qualified beneficiary to attend any of the state's institutions of higher education." The plan is available for all Michigan residents. The contract will provide for a specific number of credit hours, not to exceed the number needed for a baccalaureate degree (120), and the period of time during which the beneficiary may receive benefits.

In general, BEST will be set up to provide four years of education to children of the participants at any of the state colleges and universities to which they are accepted, regardless of the tuition cost.

The trust may also provide for the beneficiary to attend an in-state community or junior college prior to entering a baccalaureate institution, and that the beneficiary may choose to terminate the contract after completion of the degree requirements at the two-year institution, or before entering the university. A refund of the unused funds would be given at that time. (Additional details about BEST are provided in Appendix B.)

Wisconsin. Draft legislation for a tax-exempt guaranteed tuition investment program for the University of Wisconsin System outlines a tuition credit trust fund. This proposal envisions the pre-purchase of academic credits to be used within a 30-year period in an institution belonging to the University of Wisconsin System. Like the Michigan proposal, if the amount accumulated in an individual account turns out to be insufficient to cover the cost of current tuition, the trust would provide the balance. If, however, there are funds remaining after all the tuition credits purchased are used, or after a period of 30 years, they may be used by the state for general program operations.

In the Wisconsin program, credits would be purchased at a specific institution for a specific individual. However, credits purchased for one institution in the University of Wisconsin System

may be used for attendance at another institution within the System, and credits purchased for undergraduate credit may be applied toward graduate level credit. A formula based on cost per credit would be used to determine the number of credits paid for by the trust in the event of a change in institution.

However, the number of 'new' credits may not exceed the number of credits originally purchased. There are no defined minimum or maximum limits regarding the number of credits purchased.

Upon written request of the purchaser or beneficiary, if the beneficiary is at least 26 years of age, the board must return to that individual the amount equal to the current value of any unused credits. Interest earned in an individual account is not returnable.

New Jersey. The proposed New Jersey Tuition Assurance Plan would allow New Jersey residents to pre-purchase a minimum of one year's tuition on behalf of a beneficiary who has not yet entered his/her junior year in high school. At the time of purchase the sponsor must choose among participating institutions, a group which includes all New Jersey public colleges and universities and some private institutions.

The method of payment may be: 1) one lump sum for four years' tuition; 2) four annual payments; or 3) monthly payments for 12-48 months, depending on the number of years being purchased.

The total cost of participation will depend on the method of payment chosen. Monthly payments will also include some finance charge. Corporations and other institutions will be encouraged to provide payroll deduction plans to allow employees' participation. Corporations and other employers could be eligible as sponsors if they were to choose to make such arrangements available as employee fringe benefits.

If the beneficiary enrolls at the designated institution, the Plan will cover full tuition for the number of years purchased. If the beneficiary is not accepted at the designated institution and then enrolls in another New Jersey institution which charges lower tuition, the difference may be used to cover other college costs such as books, room and board. If the student enrolls at a higher cost institution, the Plan will cover tuition up to the amount charged at the initially designated institution.

If the beneficiary chooses to attend an out-of-state school, the New Jersey Plan would make available to the chosen institution an amount equal to 75 percent of the tuition cost at the original school. If the beneficiary chooses not to attend college, the investment will be refunded.

Institutions participating in the Plan must agree to accept as full payment for tuition either current resident tuition at the time of enrollment or the net annual accumulated income of the beneficiary's account. Each institution may limit the number of participants expected in the designated year.

Plans Currently Offered by Nonpublic Institutions

The concept of most innovative tuition financing strategies now being evaluated by states and state university systems originated with nonpublic colleges and universities. Several private institutions have instituted programs of tuition stabilization and prepayment programs in an effort to ease, somewhat, parental fears about the cost of a college education at a private institution in the future.

Duquesne University. Beginning in the summer of 1985, Duquesne University began offering its alumni a financing program to purchase future tuition on contract at a deep discount. If the student is not admitted or decides not to attend Duquesne, only the original investment is refunded. If he or she enters but is dismissed for academic reasons, no refund will be given. If the student attends Duquesne for one academic year, has at least a 2.5 grade point average (GPA), and then decides to transfer to another institution, Duquesne will pay the other school's tuition, up to an amount equal to its own prevailing tuition, for three more years if at least a 2.5 GPA is maintained.

Calvin College. Under a program to pre-purchase an educational tuition at Calvin College, one may purchase gift certificates for tuition equal to 1/100ths of the current year tuition cost. A certificate of 100 units would equal the full tuition cost for a year. Calvin guarantees that the relative value of a tuition unit will not change. Anyone may purchase a gift certificate and may give it to anyone. It is also completely transferable, so the purchaser may redesignate the recipient any time. However, no refunds will be given. If the named beneficiary has not reached his or her 18th birthday at the time the certificate is issued, the certificate will expire at the student's 25th birthday. If the beneficiary is 18 or older, the certificate will expire after seven years. If a certificate expires without reassignment, the benefit shall accrue to the Calvin College Scholarship Fund; in this instance the current value of the certificate may be taken as a charitable contribution to the College for tax purposes.

Pennsylvania. Last fall, the University of Pennsylvania initiated a guaranteed tuition program known as the Penn Plan. In addition to guaranteeing tuition, the Penn Plan includes the option of financing through the Plan. There are two payment options: 1) a single lump sum at the beginning of the freshman year; or 2) the applicant borrows the total tuition (minus a down payment) from the Plan agency. The loan is amortized over an extended period of up to 10 years at an annual interest rate of 11 percent, with fixed monthly payments.

To be eligible, a student must be an entering, full-time freshman student. The student's entire four years of tuition are guaranteed at the first year's rate. If the student leaves before completing four years, he or she will receive a refund based on the number of semesters attended.

Ohio Wesleyan, George Washington, Washington University, Brandeis. These are among several institutions that now offer tuition stabilization programs. Four years of tuition are paid at the current year rate in one lump sum at the beginning of the freshman year. Certain plans allow payments to be extended over a long-term period, improving cash flow problems for many families. These institutions also assist with financing either through: 1) direct lending; 2) arrangements with other private institutions to float tax-exempt bonds and fund a loan authority for financing; or 3) arrangements with local or regional banks to provide financing.

Other Financing Plans

In addition to proposed state plans and existing plans sponsored by nonpublic colleges and universities, other means of financing tuition include various forms of loans and savings or investment programs as described below.

Loan Programs. Groups of private institutions, as well as some states, have developed loan programs as lenders of last resort. A loan authority, financed by floating tax-exempt bonds, provides loans to students who are either ineligible or have used up their eligibility for other programs.

Education Savings Accounts. A specially designated form of a savings account, modeled after an Individual Retirement Account (IRA), has been proposed in many states and at the federal level. The prime use of such an account would be to pay college expenses. The accounts themselves might be owned by parents or children. Presumably there would be penalties imposed on those who use the accounts for other purposes. Similarly, there could be an extension of the permitted uses of an IRA to include paying for college.

The contributions and the interest accrued on the funds in the account could be tax-deferred or tax-exempt. Specific limits on the amount of contributions made per year could be set and the kind of financial instrument in which the funds must be kept could be regulated.

An Index Tuition/Standard Tuition Unit Plan. For a specified set of institutions the guarantor sells standard tuition units. A standard unit may be the cost of a credit at a particular institution. Tuition at all participating colleges and universities is then indexed against the standard unit price. The purchaser contracts to buy a number of standard units to be used in the future. A standard unit

might be one credit at a public university, more than one community college credit, or less than one credit at a private institution. Tuition at participating institutions is charged both in dollars and tuition units.

Although a saver is not promised which institution(s) the beneficiary may be able to attend, only that enough will be saved for the equivalent of tuition at a medium priced, four-year institution, a system of this sort does accommodate the pricing differences between institutions such as community colleges and nonpublic colleges and universities. This plan does not create pricing distortions to the extent some plans may, nor does a specific college have to be designated.

Commercial Plans. A wide variety of plans have arisen in the commercial loan and investment area apart from state and institutional sources. Both colleges and families can select from the loan and payment programs. Banks nationwide are promoting home equity loans. The nation's largest intermediary for education loans, the Student Loan Marketing Association (Sallie Mae), has made a major presence in the private loan market. Sallie Mae is a federally chartered, stockholder-owned corporation. It provides a secondary market for student loans. Sallie Mae also is testing two new loan programs, one for parents and one for professional school students, which have interest rates tied to rates of three-month Treasury Bills.

Other major financial services companies have also entered the market with loan plans, tuition futures and tuition stabilization programs.

III. Organizational and Administrative Issues

Inherent in the creation of a tuition investment program are a myriad of organizational, structural, and administrative issues that must be resolved. This section of the paper outlines a number of decisions that ultimately face policy makers. Drawing from issues faced by other states and by colleges and universities administering these plans, six major elements and options for their design are presented for consideration of a tuition investment plan.

1. Administrative Structure. There appear to be at least three general options related to the administrative structure for a tuition investment program: a state agency, a public authority, or the private market. All would require authorizing legislation.

Under an existing or newly created state agency, funds accumulated in the program could be invested and managed by the state of Illinois. Such an approach would require determining if the funds should be invested and accounted for separately or commingled with other funds collected and invested by the state. As an alternative, the state agency could contract with a private investment firm for investment and management.

Under a new public authority, accumulated funds would be invested and managed in accordance with policies established by the authority's board of directors.

The third organizational option would be for the state to facilitate and encourage private markets in tuitions. This would minimize both cost and risk to the state. But the state would also not have control, and public purposes would not necessarily be attended to. It is also possible that a private system would not have the perceived credibility of a state sponsored program, and broad participation might not take place.

2. Institutional Participants. The four major categories of institutions in Illinois are public community colleges, public universities, not-for-profit private colleges and universities, and degree granting proprietary institutions. All institutions could be included in one plan; or the plan could be restricted to only public colleges and universities; or the plan could offer an option for each major category of institutions; or conceivably, the plan could offer a separate option for each institution.

The variety of tuition rates both within a category and among the categories of institutions would complicate setting the price to be paid for participating if all institutions were to be included in one plan. This complication would be reduced somewhat by creating separate options for each category of institutions. Separate options, however, would probably require provisions for transferring from one option to another if the purchaser changed his or her mind.

3. Type of Agreement. The nature of the agreement between the proposed plan and the individual purchaser could take the form of a contract or a voucher or possibly some combination of the two.

Under a contract agreement, the purchaser would agree to specified payments in return for a guaranteed specified number of credits or tuition units at a specified institution or group of institutions at a specified time in the future. Payment options could range from one lump sum payment into the plan to payments spread over time. Payments would vary from individual to individual depending on the time at which the payments are to be made and the time at which the beneficiary enters college.

Under a tuition voucher system, the purchaser would receive in exchange for a predetermined payment a voucher that would have a specified value at a specified time in the future that could be applied toward tuition at participating institutions. Payment for vouchers would vary depending upon the time of purchase and the time at which they could be used. Vouchers could be used at a variety of institutions with a variety of tuition rates. Unlike the contract, the voucher would not guarantee full payment of tuition. In general,

the voucher system could offer greater flexibility to the purchaser in the amount and timing of purchases, as well as in the participating institutions at which the vouchers might be used.

The voucher system also could be modified to incorporate the guaranteed tuition feature of the contract agreement. That is, the value of a voucher could be established so as to guarantee tuition at public universities, for example, or to be usable toward tuition at private institutions.

Options for coverage of student tuition in the plan might include limiting the coverage to only standard full-time undergraduate tuition charges, allowing for some other undergraduate tuition charges such as part-time or summer school, or covering all tuition charges including graduate and professional schools.

4. Transferability of Benefits. If the benefits can be transferred to any individual, there may be tax consequences because it would be possible for tuition pre-purchases to be sold for a gain. Many of the programs already described allow a limited right of transfer. This is clearly desirable from the purchaser's viewpoint as it increases the likelihood of use. From the standpoint of the financial strength of the fund, limiting the use to one individual is preferable. From the parental standpoint, transferability is an important option.

5. Options for Withdrawal of Investment. If no refund is given upon withdrawal from the fund, the program would be very difficult to market. The refund of at least the original purchase amount is more marketable. Circumstances under which a refund might be allowed could include attendance at another college or at no college, service in the armed forces, death or disability. If the purchaser is able to withdraw the accumulated interest associated with the original investment, there will be a capital gain tax to be paid.

6. Risk-Sharing. A savings plan of this nature is structured to allow families to save for a postsecondary education without risk of future tuition rates exceeding their savings.

Institutions could be asked to assume the risk. They benefit from such plans by having paid-up applicant pools. The nature of the risk would primarily affect private institutions' willingness to participate, which would also depend on their confidence in the plan and their need for Illinois residents. Large, relatively wealthy institutions would be less likely to participate than those with a smaller enrollment base. Many plans influence the tuition setting process which ultimately affects institutional budgets.

The state could assume the risk. To protect itself, participation in the plan may be limited until a track record, and a reserve fund, can be established. The state also assumes a major risk if tuition rates rise faster than rate of return on the investments.

The risk could also be shared in a number of ways. For example, the state could make up some portion in the event of a deficiency - or, make up any deficiency beyond a certain level.

IV. Tax Issues

The various changes contained in the federal Income Tax Reform Act of 1986, passed by the U.S. Congress in September and signed by President Reagan on October 22, 1986, will have a mixed effect on the attractiveness of college tuition investment proposals. The cut in the top tax rate to 28 percent reduces the incentive to shelter income. However, the loss of other long-used shelters such as the Clifford Trust will make any tax advantages of new tuition investment plans more attractive.

A most significant provision contained in the new law relates to college savings plans and restricts income shifting to children. The new tax law will tax children's income, above the standard deduction, at the parents' rate for gifts made from the parent to the child. Such a change reduces the attractiveness of trusts or transfers to children under the Uniform Gift to Minors Act. As a result, the pre-purchase of tuition may become a more viable alternative to these more standard forms of college savings. For a modest amount of college savings, say four years of public college tuition, the proposed increases in the standard deduction will be large enough to provide shelter for the income derived from a child's investment. However, for most parents, the biggest change will be the taxation of unearned income in a child's name -- income from stocks or savings accounts, or the appreciation of property -- at the parents' rate.

Perhaps an equally important change is the loss of the tax deduction of most interest expenses. Using debt for college financing is considerably less burdensome when the interest costs are deductible from income taxes. Under the new federal tax law interest deductions will be limited to interest on mortgages. When the new tax laws on interest deductions take effect in 1987, it is expected that more colleges will be offering savings plans...or second mortgages. The tax bill does allow borrowing against home equity to pay education expenses with the interest being deductible.

United States Internal Revenue Service statistics indicate that the principal form of savings for many U.S. households is through building up equity in a house. The U.S. tax system has encouraged this by permitting interest and property tax payments to be deducted from income tax while failing to tax the "in-kind" income generated by living in one's own home rent-free.

The interest that accrues on savings is generally part of taxable income. The attraction of a tax-exempt investment is that the removal of the tax on interest allows funds to accumulate more rapidly.

Formerly, parents who saved for their child's postsecondary education were likely to be in a higher tax bracket at the time their child started college than when they started saving. However, the impact of the Tax Reform Act with only two tax brackets will change this for many families who may already fall in the top bracket.

Any cost estimate of a tuition investment plan must include the cost to the state of Illinois of the foregone tax revenue. The differences in after-tax levels of savings represent lost tax revenue to the federal government upon which Illinois income tax returns are based.

How tuition investment plans will be treated by the Internal Revenue Service is uncertain at this time. There are many pertinent income and gift tax questions. One important issue is the income tax assessed after withdrawal of the investment from the plan. If a participant can withdraw his or her prepayment in cash and with accumulated appreciation, then clearly there is a gain and an associated tax. Most plans offered by other institutions and states avoid this by not permitting a cash withdrawal of any gain from the program. In addition, there probably has to be a restriction on the transferability of benefits. The Michigan legislation will offer residents the choice of two plans. In "Plan A" only the original purchase amount may be withdrawn. In "Plan B" the participants may withdraw their original purchase amount plus appreciation. It is anticipated that there will be a tax liability associated with Plan B. This form will be most suitable if held by a trust or in the name of a minor. In such cases there could conceivably be low or no taxes. Whether pre-purchase tuition can be converted to tuition or, more problematically, to other educational costs at non-participating institutions, is unclear at this moment.

This uncertain tax environment needs to be considered in the development of tuition savings plans. Any program proposed for Illinois should be created carefully and with tax counsel closely involved.

V. SUITABILITY OF A TUITION INVESTMENT PLAN

The main purpose of this paper is to evaluate the suitability of one type of proposal for college savings, a state sponsored tax-exempt tuition investment program. A full evaluation of a tuition investment program should compare all alternative strategies open to families for financing college costs, including a state sponsored program. This section of the paper focuses on the basic economic and financial issues raised by any plausible version of such a plan. These principally involve questions of the advantages and equity of such a plan, its attractiveness to varying income levels, and its effects on enrollment behavior. There are also important questions related to integrating the tuition investment program with the Illinois student financial aid system.

Interests of the State

Illinois, like the individuals who consider participating, must weigh the benefits and risks of starting a tuition investment program. Consideration of the establishment of a tax-exempt tuition investment program administered by the state raises several issues and concerns. As Senate Resolution 782 indicates, the interests of individuals choosing to participate in such a program and the interests of the state of Illinois are important. In addition, there are a number of important educational and economic issues related to college financing, such as equity, cost, choice, financial aid, and participation, which must be weighed in determining the suitability of a program for Illinois.

Advantages for the State. Senate Resolution 782, in addressing the study of the suitability of a tax-exempt plan for Illinois, points out that, "...the responsibility of parents contributing to the education of their children to the extent that is reasonably possible should be encouraged and...a tax-exempt program would allow parents to contribute to a state administered investment plan..." The Illinois Board of Higher Education has long supported policies emphasizing the shared nature of college costs between the parent and the state. The Board's policies emphasize that tuition charges should be maintained at a level of one-third of instructional costs at public universities.

Probably the single overriding advantage to the state of Illinois in the development of a tuition investment program is that such a program would encourage the students and their families to save as a way to share the burden of college financing and would assist them in preparing for that responsibility and avoiding the accumulation of debt.

A second positive aspect of a tuition investment plan will be its ability to help promote enrollment in Illinois higher education institutions. By assisting parents to plan for their children's higher education within the state, more students will be able to attend participating institutions. Presumably, an investment of this nature will serve as an additional incentive to a student to attend an Illinois institution and remain in the state as a resource to its economy and citizenry.

A third advantage to the state is the political advantage of creating an attractive plan for families that can meet a real need -- saving for the college education of family members. The idea of a state sponsored program may be appealing to many families because of a perception of stability and security. Individuals may view the state's role as an attempt to stabilize tuition rates and at the same time, offer a viable, secure college savings program which would meet their need.

In 1984, the National Institute of Independent Colleges and Universities contracted with the Roper Organization, Inc. to poll families on parental savings for children's higher education expenses. Over a two-month period, 2,000 interviews were conducted representing all community sizes, geographic areas, economic levels, and employment levels.

The poll indicated that almost all (96%) parents who expect to send one or more children to college are currently saving money for some reason. "Children's education" is the second biggest reason for saving (50%), behind "emergencies" (62%), but ahead of "retirement" (37%), "vacations" (28%), "household appliances or furnishings" (25%), "a new home" (23%), and "a new or better car" (17%).

Parents of prospective college entrants are looking to multiple sources of funding -- 2.5 sources on average. As shown on Table 1, savings is the foremost resource, named by 62 percent of the parents. Half that many expect to use income they will have earned while their children are enrolled.

A large number of parents expect students themselves to contribute in one way or another -- through obtaining college scholarships (just under 4 in 10), earning money while in college (just under 4 in 10), or by taking out college loans (1 in 3).

Asked directly whether they are currently saving for their children's college education, parents of prospective college entrants confirmed their earlier answers. Only half are currently saving, and they saved an annual median of $517 in 1984. There is a higher incidence of saving, and in most cases a higher amount saved, among those in the best condition financially, among those whose children are closer to college age, and among those who plan to send more than one child to college.

Table 2 shows the poll's results for those who are currently saving or their reasons for not saving.

Disadvantages for the State. In developing a tuition investment program, the state of Illinois assumes the risk that the growth in invested tuition prepayments will not match the future increases in tuition. Many of the current and proposed tax-exempt tuition investment programs contain the potential risk that tuition could soar for unanticipated reasons and investments would not yield as great a return as anticipated. The cyclical changes in investment returns and interest rates over the last decade suggest the unpredictability of this element.

Tuition has steadily increased over the past two decades but at varying rates from year to year, as Table 3 shows. The unpredictability of tuition increases is related to the fact that it is only one of several sources of revenue for meeting higher education's

resource requirements. Total expenditures for higher education in Illinois did not keep pace with new program development and enrollment increases and lost considerable ground to inflation during the seventies and early eighties. These losses have been offset to a considerable extent in recent years by increased revenue for higher education from the state's General Revenue Fund and tuition. Future tuition increases in public colleges and universities will be affected by the availability of state and other revenues to keep pace with future inflation and necessary resources for changing higher education programs.

Actuarial assumptions used in the college tuition financing programs may lead to artificially imposed limits on tuition increases. For example, if plan organizers and investors assume that tuition will increase at an annual rate of five percent over the next decade, this may actually impose pressure to limit tuition increases despite other factors warranting potentially larger increases. The end result would have the state of Illinois financing the shortfall through available General Revenue Funds.

The state can reduce its risk by adopting more restrictive policies in the design of its tuition plan. Limiting the number of individual participants and imposing early withdrawal penalties are two examples of measures to reduce risks to the state.

A second disadvantage to the state is the loss in revenue to the state through the exemption of state taxes on income earned as a result of participation in a tuition investment plan. Table 4 illustrates how the tax loss to the state could increase from year to year as the size of the investment fund increases.

A third disadvantage to the state is that it must bear the unknown administrative expense and responsibility for the program. Depending on the type of organizational and administrative structure chosen, administrative costs could be a significant factor. The entire program must be organized from the beginning and the state has many options to consider with certain educational and economic considerations associated with each option.

Interests of the Individual and Family

There are many factors that ultimately determine whether or not a student attends college, including the family's socio-economic status, the student's scholastic ability and achievement, the family's perception of the value of a college education, and the family's ability to marshal the resources necessary to pay for a college education.

Evidence from the Federal Reserve System's 1983 Survey of Consumer Finances suggests that liquidity constraints may be a real factor for many families sending their children to college. Table 5 shows that families with heads of households in the age range of most

college parents hold a substantial portion of their assets in the form of equity in their own home, and have substantial mortgage debt obligations. Median amounts of consumer debt roughly offset median holdings of liquid assets, and holdings of non-liquid financial assets (stocks, bonds, trusts) are small for the median family.

A family needs to consider the pros and cons of tax-exempt savings as compared to taxable forms of savings. The role of the loan programs available to students and parents and their tax consequences also needs to be considered, as does the age of the child, the ability to transfer assets to minors for the purpose of paying for college, and other forms of financial aid that may be available. Given the bewildering array of options for saving and obtaining other resources to finance the cost of a college education, parental use of a tax-exempt tuition investment program will depend on its relative benefits and risks in comparison to other financing strategies.

Advantages for the Individual and Family. The state of Illinois, like other states across the nation, has developed public policy that parents bear a share of the burden of financing their children's college education. As costs of college have risen, it has become increasingly unrealistic to assume that most parents would be able to finance their share of college costs out of current income, especially if their children attend independent institutions. Therefore, parents search for devices that will help spread the burden of paying for college over longer periods of time -- through both savings and loan mechanisms. Therein lies the significant advantage of a tuition investment program -- a hedge against inflationary costs of college tuition guaranteeing that their investment will cover cost increases.

Development of a tax-exempt tuition investment plan appeals to parents in several ways, but a most prominent appeal is to give them a tuition inflation advantage.

A second advantage relates to one of the first decisions to be made by parents -- whether to accumulate funds in advance or to borrow money at the time of their childrens' enrollment in college. The attraction of loans for parents (beyond the fact that they are not necessarily responsible for their repayment) is that the repayment is pushed far out into the future. In periods of significant inflation, the loan is repaid with cheaper dollars. There was an additional aspect of loans that made them attractive to parents: the interest on the loan was tax deductible under the old tax law. The loss of interest deductibility for student loans will increase the attractiveness of savings and investment programs, particularly with inflation rates very low. Some of the current programs offer payroll deduction features which add to their attractiveness. The new tax reform law will make savings vehicles more attractive as families will be encouraged to save ahead instead of borrow. One strategy that many families currently follow is to rely on the Guaranteed Student Loan

(GSL) program. Parents may or may not help their child to repay the loan, but the GSL program is an alternative for delaying any financial outlay or entirely shifting the burden of loan repayment to their child.

Presented with possible incentives for saving toward their children's college education, parents who expect to send one or more children to college indicate strongly that the more tax-free it is, the greater the incentive to save: a third advantage of tuition investment programs.

Over four in ten parents say they would save more than they are now saving if the federal government gave people a tax break in the form of deductions or tax credits for money put into an education savings account. Three in ten would not save more, but would put some of what they are now saving into such an account. The higher the income of parents, the more inclined they would be to save more given tax breaks.

Table 6 illustrates the potential for savings if the interest earnings are tax exempt for both state and federal taxes. The analysis demonstrates the advantage this program would have even if investment returns were only average.

The fact that a tuition investment program is tax-exempt implies that more of the benefits go to upper income families. The value of tax deduction or tax deferral is greater for a family whose income is higher because that family is in a higher tax bracket.

Disadvantages for the Individual and Family. The family considering the investment of funds in a state sponsored investment program must use the same critical judgment that it uses in selecting any savings or investment vehicle for financing college. Clearly, the family must consider the rate of return and ask whether or not the return from the state program is better than other alternatives. Until the state program has a proven investment "track record" there will be an inherent risk that other vehicles could do better in their return on the money invested.

Another important consideration for families is the number of institutions in the plan. A large number provides a broader range of institutional choice from a geographical, programmatic, and academic vantage. The inclusion of out-of-state or independent institutions within a plan may provide even more appeal to some families. Choosing an institution for a child at an early age is a very risky proposition. There are over 3,300 institutions in the nation offering great diversity in academic programs. Choosing a particular institution for a child at too early an age could be a significant disadvantage.

Parents may also be more inclined to invest in such a program if the payments can be used for any of their children at his or her choice of institution. Choice of payment schedules also increases or decreases the plan's attractiveness to families. Large, lump sum payments may discourage lower income families, whereas multi-year payment schedules may broaden the plan's appeal.

A third potential disadvantage for the family is that the invested money is locked into one program -- college education. In the Roper Survey, only one person in three indicated they would favor a "dedicated" college savings account, whereas two in three favor a flexible plan wherein the money could be used for college and/or retirement.

A fourth risk for a family entering such a program centers upon the withdrawal features of the plan. Withdrawal features are important. Parents will want to use the investment for college, as intended, or obtain a significant gain should their children choose not to attend a college or university. A penalty for early withdrawal could be a most significant disadvantage, depending upon the penalty amount. Some independent institutions' plans return only the principal invested with no interest earnings -- a sizable penalty for withdrawal from the plan.

Impact on Student Financial Aid. Lower and middle income families who have saved for their child's college education face reality when the family's financial well-being is assessed by the financial aid system for determining financial aid eligibility. What may have seemed like an asset during the period of saving becomes a liability when determining financial need. The amount of savings of a family is included as part of its assets. A proportion of the value of total family assets is included in the family's contribution to college costs.

The American Council on Education reports that 47 percent of the full-time undergraduate students at the nation's universities and two and four-year colleges received some form of financial assistance. About 40 percent of the aided students were from families with incomes of less than $15,000; 35 percent had family incomes in the $15,000 to $30,000 range; and 25 percent were from families with incomes above $30,000. The treatment of the tax-exempt tuition plan in the calculation of student need could have a direct impact on the family's decision to participate, particularly among those families in the $30,000 and above income levels, or who fall in the new 28 percent tax bracket.

Effect on Institutional Choice. The case for tax-exempt tuition investment programs having an influence on students' college choice is not clear at this time. The general sense is that such plans have little effect on total college enrollment but could influence shifts within sectors, for instance, if only public universities were involved in such a plan.

VI. SUMMARY

Rising tuition and fees are a concern. Moreover, families and students alike are more consumer-oriented and financially sophisticated, and expect a choice of financing options to meet their needs. Added to this is the decreasing number of college students, which has led many institutions to adopt competitive approaches to attracting new students. Consequently, many institutions are implementing or considering programs to help families and students make tuition payments.

Senate Resolution 782 charged the Board of Higher Education to analyze the suitability of a tax-exempt tuition program for Illinois. In doing so, this paper examined not only the financial issues faced by families which may make a particular program attractive or unattractive, but also the issues of financial benefit and risk to the state itself, and the component features of many plans and their design options.

In the development of a program for Illinois, the short-term political benefits to the state are matched by long-term benefits of encouraging individuals to save as a means of sharing in the costs of providing a college education. At the same time, the state will bear the administrative responsibility for the program and assume the financial risk that tuition charges will not increase faster than earnings from the monies invested.

For the individual considering a tuition investment program as a vehicle to finance a college education, the guarantee that his or her investment will match the rate of increase in college tuition costs is quite attractive. If the program is tax exempt and allows choice of attendance at a variety of institutions, the program has many advantages for the family.

At the same time, the family or individual encounters a number of risks. Institutional choice may be limited, withdrawal of investments may carry a heavy penalty if the child chooses not to attend a college participating in the program, and the family's investment dollars are dedicated toward a single goal -- education -- and cannot be used for anything else. The individual must also ask whether or not other investments could return a better yield.

The suitability of a tuition investment plan for the state of Illinois depends greatly upon the resolution of complex issues related to the creation of a savings and investment program as well as issues related to taxation under the new federal tax laws. The costs and risks to the state need to be considered carefully in addition to the potential for benefit to the family. Given the bewildering array of options for saving and obtaining other resources to finance the cost of a college education, the suitability of a state sponsored tuition investment program will depend on its relative benefits and risks in comparison to other financing strategies generally available to individuals.

Table 1

SOURCES OF COLLEGE FINANCING BY INCOME LEVEL

	Total Parents	Household Income: Under $10,000	$10,000-Under $20,000	$20,000-Under $30,000	$30,000+
Sources of College Financing					
Savings we've accumulated	62%	32%	57%	64%	78%
Scholarships from college	38	29	28	37	48
Money student will earn from job while in college	38	35	28	37	48
Student loans children will take out	34	44	35	33	29
Income we'll have while they are enrolled	31	17	22	32	42
Federal/state grants	24	36	24	33	18
Help from grandparents	9	5	13	9	9
Help from other relatives	4	5	7	5	-
Other sources (vol.)	6	9	4	6	4
Don't know	4	12	3	2	3

Source: National Institute of Independent Colleges and Universities, 1984

Table 2

PARENTAL SAVINGS FOR COLLEGE

	Percent Who Are Currently Saving For Children's College Education	Median Amount Now Saving Per Year
Total Parents	51%	$517
Household Income		
Under $10,000	17%	$120
$10,000 - Under $20,000	45	140
$20,000 - Under $30,000	52	466
$30,000 or More	70	904
Age of Children Expected to Go to College		
Under 13	51	443
13 - 18	58	775
Number of Children Expected To Go to College		
One	46	494
Two	55	500
Three or More	55	591

Reasons for Not Saving

Cannot afford to save now, but probably will later on	48%
Cannot afford to save now and probably won't be able to in future	23
Child is too young, but will probably save later	20
Will borrow money to send child to college	6
Don't feel it's my responsibility, it's child's	5
Government programs will finance child's college education	5
Already have enough put aside	2
Will sell assets to send child to college	2
Other reasons	13
Don't know	2

Source: National Institute of Independent Colleges and Universities, 1984

Table 3

TRENDS IN ILLINOIS TUITION INCOME BY SECTOR

Fiscal Year	Public Universities*	Percent Change	Community Colleges*	Percent Change	Private Four-Year*	Percent Change
1959	$ 164	-	$ 39	-	$ 709	-
1960	183	11.6%	34	(12.8%)	760	7.2%
1961	193	5.5	34	0.0	762	.3
1962	202	4.7	52	52.9	882	15.7
1963	204	1.0	66	26.9	932	5.7
1964	220	7.8	86	30.3	1,008	8.2
1965	218	(.9)	88	2.3	1,080	7.1
1966	236	8.3	121	37.5	1,174	8.7
1967	240	1.7	150	24.0	1,247	6.2
1968	247	2.9	122	(18.7)	1,338	7.3
1969	263	6.5	140	14.8	1,463	9.3
1970	344	30.8	167	19.3	1,597	9.2
1971	431	25.3	203	21.6	1,794	12.3
1972	541	25.5	237	16.7	1,915	6.7
1973	607	12.2	247	4.2	2,025	5.7
1974	605	(.3)	262	6.1	2,163	6.8
1975	606	.2	306	16.8	2,320	7.3
1976	614	1.3	317	3.6	2,505	8.0
1977	622	1.3	386	21.8	2,695	7.6
1978	727	16.9	412	6.7	2,883	7.0
1979	757	4.1	425	3.2	3,160	9.6
1980	828	9.4	471	10.8	3,394	7.4
1981	904	9.2	509	8.1	3,775	11.2
1982	1,017	12.5	539	5.9	4,242	12.4
1983	1,156	13.7	612	13.5	4,845	14.2
1984	1,334	15.4	704	15.0	5,266	8.7
1985	1,503	12.7	732	4.0	5,748	9.2
1986	1,615	7.5	776	6.0	6,263	9.0

* Mean-weighted tuition and fees.

Table 4

ANALYSIS OF ANNUAL INVESTMENT IN A STATE SPONSORED PROGRAM

	Implications for Individual					Implications for State Per Cohort	
	One Year Of Tuition[1]	Family Contribution[2]	Interest Not Taxed[2]	State Tax Not Paid[3]	Federal Tax Not Paid[4]	Size of Fund[5]	State Taxes Not Paid[6]
Year 1	$1,200	$ 500	$-0-	$ -0-	$ -0-	$ 6,000,000	$ -0-
Year 2	1,260	1,025	25	.63	7.00	12,300,000	7,600
Year 3	1,323	1,576	51	1.28	14.28	18,912,000	15,400
Year 4	1,389	2,155	79	1.98	22.12	25,860,000	23,800
Year 5	1,459	2,763	108	2.70	30.25	33,156,000	32,400
Year 6	1,532	3,401	138	3.45	38.64	40,812,000	41,400
Year 7	1,608	4,071	170	4.25	47.60	48,852,000	51,000
Year 8	1,688	4,774	204	5.10	57.12	57,288,000	61,200
Year 9	1,773	5,513	239	5.98	66.92	66,156,000	71,800
Year 10	1,861	6,289	276	6.90	77.28	75,468,000	82,800
Year 11	1,955	7,103	314	7.85	87.92	85,236,000	94,200
Year 12	2,052	7,959	355	8.88	99.40	95,508,000	106,600
Year 13	2,155	8,856	398	9.95	111.44	106,272,000	119,400
Year 14	2,262	9,799	443	11.08	124.04	117,588,000	133,000
Year 15	2,375	10,789	490	12.25	137.20	129,468,000	147,000
Year 16	2,494	11,829	539	13.48	150.92	141,948,000	161,800
Year 17	2,619	12,920	591	14.78	165.48	155,040,000	177,400
Year 18	2,750	14,066	646	16.15	180.88	168,792,000	193,800

[1]Assumes one year of tuition at a public university is $1,200 and increases at a rate of 5% per year.

[2]Assumes each family contributes $500 per year and annual interest on contribution is 5% per year.

[3]Calculated at 2.5%.

[4]Calculated at 28%.

[5]Assumes that the number of participants is equal to 10% of public university undergraduate enrollment age 24 or younger in Fall 1984 or 12,000 participants (Column 2 x 12,000 = Size of Fund).

[6]Assumes 12,000 participants (Column 4 x 12,000 = State Taxes Not Paid by Participants).

Source: Illinois Board of Higher Education

Table 5

MEDIAN HOLDINGS OF VARIOUS ASSETS
AND LIABILITIES FOR FAMILIES

	Head Aged 35-44*	Head Aged 45-54*
Mortgage Debt	$25,268	$16,167
Net Equity in Own Home	40,600	50,000
Consumer Debt Outstanding	3,030	3,152
Liquid Assets	3,000	3,308
Non-Liquid Financial Assets	750	823
Net Worth	28,721	43,797

* For families owing such debts and owning such assets.

Source: Robert B. Avery, "Survey of Consumer Finances," Federal Reserve Bulletin, September 1984.

Table 6

TAX BREAK EFFECT ON SAVINGS
BY HOUSEHOLD INCOME LEVEL

	Total Parents	Household Income: Under $10,000	$10,000- Under $20,000	$20,000- Under $30,000	$30,000+
If tax breaks were given on education savings:					
Save more, and put some of it in education savings account	43%	37%	41%	43%	47%
Save same amount, but put some of it in education savings account	30	25	27	29	36
Not change savings habits	22	27	29	22	14
Don't know	5	11	3	6	3

Source: Roper Organization, 1984

Appendix A

SENATE RESOLUTION 782

WHEREAS, The public policy of this state should be that qualified young people should not be denied an opportunity to obtain a college education because of a lack of personal financial resources; and

WHEREAS, The responsibility of parents contributing to education of their children to the extent that is reasonably possible should be encouraged; and

WHEREAS, Even dedicated and sacrificial parental investment plans are often inadequate to meet the costs of education for their children; and

WHEREAS, A coordinated, combined investment program is often more reliable and profitable than individual efforts; and

WHEREAS, Creative financing techniques for higher education should be encouraged; and

WHEREAS, A tax-exempt program which would allow parents to contribute to a state-administered investment plan has received considerable study by researchers in the State of Michigan; therefore, be it

RESOLVED, BY THE SENATE OF THE EIGHTY-FOURTH GENERAL ASSEMBLY OF THE STATE OF ILLINOIS, that the Illinois Board of Higher Education analyze the suitability of a tax-exempt investment plan for the State of Illinois and submit a report by December 1, 1986 to the General Assembly relative to their analysis; and be it further

RESOLVED, That the Board of Higher Education seek the assistance of the State Treasurer, the Illinois Economic and Fiscal Commission, the Bureau of the Budget, the Illinois State

Scholarship Commission and any other state agency it deems could be helpful in the analysis and preparation of the report; and be it further

RESOLVED, That a suitable copy of this resolution be transmitted to the Illinois Board of Higher Education.

Appendix B

Michigan

The most widely publicized among the state plans is the proposed Baccalaureate Education System Trust (BEST) in Michigan. The plan has passed one chamber of the Michigan General Assembly and is being considered by a Senate committee during their Fall 1986 session. The legislation outlining BEST proposes an independent agency, within the Department of the Treasury, governed by its own board.

The function of the trust would be to "contract, on behalf of the state, with purchasers for the advanced payment of tuition for a qualified beneficiary to attend any of the state's institutions of higher education." The plan is available for all Michigan residents. The contract will provide for a specific number of credit hours, not to exceed the number needed for a baccalaureate degree (120), and the period of time during which the beneficiary may receive benefits.

In general, BEST will be set up to provide four years of education to children of the participants at any of the state colleges and universities to which they are accepted, regardless of the tuition cost. The nominal amount required for investment by parents will be determined on the basis of: 1) the average prevailing tuition at Michigan four-year institutions discounted at the time of the investment; 2) the length of time until the year of first use specified in the contract; 3) the method of payment chosen; and 4) the amount of flexibility with regard to withdrawal features.

As the plan has been conceived the trust would offer at least three payment options: one lump sum, periodic installment payments, or payroll deductions. The length of time over which payments are made will be a determinant of the total cost to the participant -- longer term financing will cost more.

The fourth determinant of the contracted price will be the choice of flexibility regarding a refund in case of withdrawal. There would be at least two options in this regard. Under Plan A the nominal payment(s) may be withdrawn, but the investment income attributable to the payments would not be refunded. Plan B would allow the refund of both principle and interest to the participant. This would increase the total cost of the investment; in addition, the participant would be liable for capital gains tax on the investment income.

Termination of a contract would be allowed (and a refund given) in the case of: 1) the beneficiary dies; 2) the beneficiary is not admitted to a state institution of higher education; 3) the beneficiary certifies, after attaining the age of majority (21) that he or

she has decided not to attend college. In these instances, the amount of a refund shall not exceed the prevailing tuition cost on the date of termination at the state college which charges the lowest rate of tuition.

Persons entitled to a refund may also direct that payment of the refund be made directly to an independent, degree-granting college or university in Michigan. The refund, in this case, shall not be greater than the prevailing average tuition at Michigan's public four-year institutions.

The trust may also provide for the beneficiary to attend an in-state community or junior college prior to entering a baccalaureate institution, and that the beneficiary may choose to terminate the contract after completion of the degree requirements at the two-year institution, or before entering the university. A refund of the unused funds would be given at that time.

Contracts purchased for a child who may attend college in less than four years after the contract is entered into would be based upon either attendance and tuition at a specific institution, or the state university with highest prevailing tuition cost for the number of credit hours covered.

Differences in the cost of actual tuition and the accumulated savings in an individual account will be the responsibility of the trust: if tuition is greater than the accumulated investment, the trust will make up the difference; if tuition is lower, the difference reverts to the trust. In order to minimize the risk to the state, provision is made to allow the limitation of participation so that the discount on current tuition can be adjusted based on experience. Periodic adjustments in the required investment for new participants may be made to ensure the actuarial soundness of the trust.

Although assets of the trust may not be considered state funds, the board may make the decision to pool funds, for purposes of investment, with investments of the state, thereby taking advantage of the rate of return achieved through the use of a large portfolio.

The attractiveness of this program to families, in large part, is that the interest on the investment, as well as the subsequent value of the tuition, can be made exempt from state and federal taxes. The state of Michigan has not yet sought a ruling from the IRS regarding the tax status of this type of investment.

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